SUPREME COURT, U. S.

No. 859

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

WILLIAM D. FRAZELL and MARTHA T. FRAZELL,
Petitioners

vs.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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LECOMTE, SHREVEPORT, LOUISIANA

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

William D. Frazell and Martha T. Frazell, Petitioners, pray that a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit entered in the above entitled case on August 5, 1964.

CITATIONS TO OPINIONS BELOW

The opinion of the United States District Court for the Western District of Louisiana, rendering judgment for the petitioners as prayed for, is reported in 213 F.

Supp. 457. (R. 159, Infra p. 20). The opinion of the Circuit Court of Appeals reversing the judgment of the District Court is reported in 335 F. 2d 487 (R. 207, Infra p. 46). The per curiam of the Circuit Court of Appeals denying a rehearing is unreported, and appears Infra p. 55 (R. 332). The three opinions are printed in Appendix "B" to this Petition.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on August 5, 1964 (R. 207, Infra p. 46). Rehearing was denied on December 15, 1964 (R. 332, Infra p. 55). The jurisdiction of this Court is invoked under 28 *U.S.C.*, Section 1254(1).

QUESTIONS PRESENTED

1. Where taxpayer, a geologist, enters into a partnership agreement with two investors who agree to advance all funds necessary for the acquisition, development and operation of oil and gas properties, and taxpayer is to contribute geological maps and data previously acquired by him, as well as full time services, for a stated salary, and a certain interest in the venture and the net profits thereof to be assigned to him after the investors have been fully repaid all contributions made by them, is the taxpayer liable for income tax on the value of his interest in the partnership venture, as ordinary income, at the time when the contributions of his co-adventurers have been fully repaid, in view of Subchapter K of the Internal Revenue Code (26 USC 701 et seq)?

2. In the case above referred to, if the three partners, or co-adventurers, form a corporation to which they assign all their interest in the partnership for stock issued to them in the same proportion as their partnership interest, is the taxpayer liable for an income tax on the value of the corporate stock received by him, in view of Section 351(a) of the Internal Revenue Code?

STATEMENT OF THE CASE

Petitioners, husband and wife, filed suit in the United States District Court for the Western District of Louisiana to recover $32,064.90 each, with statutory interest, being income taxes paid by them as a result of a deficiency assessment made by the Commissioner of Internal Revenue for the year 1955 (R. 4-8). The facts are undisputed, and the case was submitted on the pleadings, stipulations, and evidence taken out of Court. The facts as stated by the District Judge, and as revealed by the record, are:

William D. Frazell (Frazell) is a geologist and was employed as such by Union Producing Company, for fourteen years on a strictly salary basis. He preferred to acquire and operate mineral properties independently and in 1951 became associated with N. H. Wheless and W. C. Woolf in a joint venture for the acquisition, development, and operation of oil and gas leases and properties. (R. 159-160) Their agreement was reduced to writing (R. 22-23) and provided that Frazell would contribute certain geological maps and data obtained by him and relating to certain areas in Texas where the venture was to operate

together with his full time services, and his partners were to contribute all cash necessary for the venture. The title to all properties acquired was to remain in the names of Wheless and Woolf until all of their financial contributions were repaid to them in full out of profits of the operation (R. 160). After recovery of costs and expenses by Wheless and Woolf, Frazell, upon written request, was to be assigned his specified interest in the properties and thereafter share in the profits of operation. Frazell was to receive $675.00 and expenses monthly as a drawing account (R. 160). His monthly drawing account was charged to expense of operation and reported by him as ordinary income, but his interest in the venture properties was not so treated. (R. 96, 103). The agreement was subject to cancellation on 30-days' notice by either party, and in such event Frazell was to retain his interest in all properties which had been acquired. (R. 33).

From information contained in the maps and data supplied by Frazell 27 producing oil and gas wells were drilled and the venture was highly successful (R. 162, 178, 179). In 1955 the partners incorporated their venture, and formed the WWF Oil Corporation to which they transferred their property interests in the venture in exchange for stock proportionately. (R. 34, 40, 162, 163). In their 1955 income tax returns the Frazells treated their receipt of corporate stock as a tax-free exchange of property for stock (R. 163), but the District Director of Internal Revenue ruled that the transfer of Frazell's interest was taxable as ordinary income since he had only a "contingent interest", and owned nothing until he received

the stock in 1955. He accordingly treated the receipt of stock as additional compensation and assessed deficiencies which were paid, and this suit for refund followed. (R. 164).

The District Judge ruled that the evidence as a whole shows that the agreement between Frazell, Wheless and Woolf entered into in 1951 constituted a joint venture as distinguished from a contract of employment (R. 183); that the stock issued to Frazell in 1955 in exchange for his interest in the venture was not additional compensation for services rendered, but a tax-free exchange of property for stock as contemplated by Section 351(a) of the Internal Revenue Code (R. 166, 167, 183) and for the "factual reasons" set forth in his written opinion rendered judgment for the petitioners as prayed for (R. 183).

The Court of Appeals for the Fifth Circuit, two Judges concurring and one dissenting (R. 207) reversed, and held that Frazell's interest in the venture did not become possessory until 1955, and that so much of the stock received by him at that time in compensation for services was taxable to him under Treasury Regulation, Sec. 1.721(b)(1) - (R. 212). The Appellate Court further ruled that the portion of the interest received by Frazell in return for his contribution of maps and data to the venture was not taxable (R. 213). The case was accordingly remanded to the district court "to determine whether the maps . . . were contributed by Frazell to the oil venture created by the 1951 contract. If the court finds that the maps were so contributed, it shall determine their value as of the time of their contribution." (R. 214) Judge

Hutcheson dissented and stated that "the district judge's opinion is uncontrovertible, that the contentions of the appellant are technical and unsubstantial, and the majority opinion is not a correct statement of the law." (R. 215)

Taxpayers filed a timely petition for rehearing (R. 220 et seq.) which was denied in a per curiam of the Court on December 15, 1964 (R. 332 et seq.).

REASONS FOR GRANTING THE WRIT

1. The decisions of the Court of Appeals are directly in conflict with decisions of the 9th and 10th Circuits in the following cases:

> *Kasishke v. Baker*, (10 Cir) 146 F. 2d 113, 115, Cert. Den. 325 US 856, 89 L ed 1976
>
> *Kasishke v. Keppler* (10 Cir) 158 F 2d 809
>
> *Kaye v. Smitherman* (10 Cir) 225 F 2d 583, 593, Cert. Den. 350 US 913, 100 L ed 800
>
> *Farris v. C.I.R.* (10 Cir) 222 F 2d 320
>
> *United States v. U.S. National Bank, Exec.* (9 Cir) 239 F 2d 475.

The *Kasishke* cases involved facts that parallel the instant case. The Tenth Circuit there held that the interests of the geologists, who contributed their information, skill and services to the venture, attached at the moment the oil and gas leases were acquired. In *Kaye v. Smitherman*, supra, the Tenth Circuit reached a similar result. The Fifth Circuit opinion in the present case holding that

Frazell had only a contingent interest or "springing executory interest" is obviously in conflict with the Tenth Circuit rulings in the *Kasishke* and *Kaye v. Smitherman* cases.

Farris v. Commissioner of Internal Revenue (10 Cir) 222 F. 2d 323, was an income tax case in which the Court stated that "the question presented by this appeal is whether in 1948 the petitioner, Leonard A. Farris, received ordinary income in the amount of $12,500.00 in connection with the liquidation of a partnership of which he was a member." The taxpayer contributed only his time, knowledge and experience in the acquisition and development of oil properties which were held in the name of the co-partner who furnished the finances, just as Wheless and Woolf did in the case at bar. The Court of Appeals held that "the contribution of services by one partner constituted a contribution to the capital structure and made him one of the joint owners and possessors of the property of the partnership." The Tax Court was reversed and the taxpayer was relieved of the tax. The Fifth Circuit is therefore in conflict with the *Farris* decision.

United States v. United States National Bank (CA 9) 239 F. 2d 475, was also a tax case in which the taxpayer contributed services only to a joint venture for the acquisition and sale of timber lands. On liquidation of the venture taxpayer received his proportionate interest in the properties which were held in the name of his co-adventurer. The Commissioner assessed a deficiency in tax on the value of the properties received by the taxpayer,

as in Frazell's case here, but the Ninth Circuit held that the assets received "constituted distribution of property in the nontaxable dissolution of a joint venture, and that the fair value thereof did not constitute compensation for personal services." The opinion of the Fifth Circuit which petitioners complain of is in conflict with the Ninth Circuit ruling.

2. The questions presented here are of great importance to the entire oil and gas business which is one of the nation's largest and most essential industries. The Fifth Circuit in the case of *In re Weinert* (CA 5) 294 F. 2d 750, 757, referred to joint ventures such as Frazell's as "sharing arrangements created out of the exigencies of the oil and gas business and necessary in many cases to development of oil and gas property." The decisions in the case at bar have been the occasion for favorable comment on the district court ruling, and unfavorable criticism of the Court of Appeals decision by a number of tax periodicals and experts in the field of oil and gas taxation.(1) Briefs amici curiae in support of taxpayers' position have been filed herein by Leland E. Fiske, author of "Federal Taxation of Oil and Gas Transactions", by Marvin K. Collie and Robert K. Jewett contributors of tax articles to Southwestern Legal Foundation Institute on Oil and Gas Law and Taxation and other tax law re-

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(1) *Oil and Gas Tax Quarterly* 1963, Vol. 13, No. 1, p. 25 et seq.

Oil and Gas Taxes, P-H, Par. 115.2.

Oil and Gas Tax Quarterly, Oct. 1964, Vol. 14, No. 1, p. 18 et seq.

views, and by New York counsel representing The Association of Real Estate Syndicators, Inc. The importance of the decision to the oil and gas industry is thus stated in the September 1964 issue of *"Oil and Gas Taxes"*, P-H, Par. 115.2:

> *"Fifth Circuit Casts a Dark Shadow over Sharing Agreements.* In a momentous decision the important Fifth Circuit has just shaken the very roots of the sharing concept. Most natural resource tax men felt that the result was fairly well established when you joined together to develop a mineral property the contribution whether in capital or services did not create a taxable event. See, GMC 22730, 1941-1 Cum. Bull. 214; Rev. Rul. 54-84, 1954-1 Cum. Bull. 284; Dearing v. Commissioner (CCA-5, 1939), 102 F. 2d 91, AFTR, 632; Par. 7.03 Income Taxation of Oil and Gas Production, Breeding and Burton, Prentice-Hall, Inc., Par. 1008, 3001.2(1)."

The October 1964 issue of the *Oil and Gas Tax Quarterly*, Vol. 14, p. 18 et seq., makes the following comment on the Fifth Circuit ruling:

> "The only support cited by the Court for its conclusion is Regulation 1.721(b)(1). Far from supporting the Court's conclusion, the cited regulation seems to be a direct contradiction of the Court's holding." (p. 24)

> "The Fifth Circuit's conclusion in this case seems to be erroneous and it is hoped that Frazell will not become an established precedent in this area of taxation. It is believed that the District Court was correct in holding that the Y Corporation stock received by F was received by F in a tax-free exchange under Section 351(a)." (p. 29)

An article reviewing the decision of the Court of Appeals herein is in course of preparation and publication by the Stanford Law Review.

3. The exact questions presented here have not been decided by this Court, and are of great importance in the administration of the income tax laws relating to partnerships, and the incorporation of partnership interests. The decision of the Appellate Court is in conflict with any reasonable or practical interpretation of the provisions of subchapter K of the Internal Revenue Code (26 U.S.C. 701 et seq.) as written, and as explained in the income tax regulations and the legislative history of the 1954 Code. The pertinent paragraphs of the Code, the regulations and the legislative history are set forth in Appendix "A" hereto. (Infra p. 14 et seq.)

The Court of Appeals based its decision on Regulations Section 1.721-1. This regulation relates to contributions of property to a partnership and in accordance with Section 721 of the Internal Revenue Code states that no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership. However the regulation adds a provision that "To the extent that any of the partners gives up any of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation) Section 721 does not apply." Since the agreement for the venture with Frazell provides

that hs copartners are to be repaid their contributions in full before Frazell could receive an assignment of his interest in the properties and participate in production (R. 29-30) and the District Judge found this to be a fact (R. 161) it is obvious that Regulations Sec. 1.721-1 furnishes no basis for a tax, and certainly Section 721 of the Code does not. When Frazell received his interest in the venture upon its liquidation in 1955, the distribution was non-taxable under Section 731 of the Code which specifically states that such a liquidation is non-taxable (App. A, p. 15 Infra) and when he and his co-partners transferred their interests in the partnership properties to the W.W.F. Corporation, (R. 40-42) there was a transfer of property and physical assets to the corporation in exchange for stock which is non-taxable under the provisions of Section 351(a) of the Code. (App. A, p. 16, Infra). The District Judge found this to be a fact (R. 183, p. 44-45 Infra). It is a matter of great importance to all partnerships dealing in sharing arrangements or carried interests, and the like, to have this court's authoritative opinion as to these matters.

4. Moreover, there are certain rulings made in the course of the opinion which appear to be in conflict with applicable decisions of this Court. The Fifth Circuit disregarded the findings of fact made by the district court (R. 166, 167 and 183) and reached conclusions in conflict therewith and contrary to the rulings of this Court. Findings which have substantial support in the evidence should be accepted by the Appellate Court as unassailable.

Alabama Power Co. v. Ickes, 302 US 464, 82, L.ed. 374.

United States v. Singer Mfg. Co., 374 US 174, 10 L. ed. 2d 823.

The ruling of the Court of Appeals that Frazell's partnership interest was a "springing executory interest" which did not become possessory until 1955 is not only in conflict with the decisions of the Tenth Circuit cited in the first paragraph of this heading, but is incompatible with the rulings of this Court in the cases referred to hereinbelow.

Paul v. Cullum, 132 US 539, 33 L. ed., 430, holds that a partner who contributes services for an interest in the venture to be received on termination thereof, cannot be regarded merely as receiving compensation for services but a partnership interest in the venture. The earlier case of *Seymour v. Freer*, 75 US (8 Wall) 202, 19 L.ed. 306, held that such a partnership agreement created an equitable interest in properties taken in the name of another partner for partnership purposes. And the more recent case of *Helvering v. Cement Investors, Inc.*, 316 US 527, 532, 533, 86 L. ed. 1649, 1654, states that there "is no reason to conclude that a beneficial owner of, or equitable claimant to, property is precluded from consummating an exchange which qualifies under Section 112(b)(5) merely because the actual conveyance is made by his trustee or title holder." Section 351(a) of the 1954 Code is of course the counterpart of Section 112(b)(5) of the Revenue Act of 1936.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted, irrespective of the Court of Appeals order remanding the case for a determination as to whether or not petitioners were entitled to a credit against the tax paid. The decision goes to the merits of the case and finally disposes of the real issues raised in the pleadings. This Court has granted certiorari to review non-final judgments involving an issue fundamental to the further conduct of the case, or where there is a conflict on a question of law with another Court of Appeals.(2) 26 I.R.C. 1254(1) grants jurisdiction by certiorari of an extremely comprehensive nature and extends to any civil case at any stage of the proceedings.(3)

Respectfully submitted,

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(2) *Land v. Dollar*, 330 US 731, 734, 91 L. ed. 1209, 1211 fn.2. *United States v. General Motors Corp.*, 323 US 373, 377, 89 L.ed. 311, 318.

(3) *Forsyth v. Hammond*, 166 US 506, 513, 41 L.ed. 1095, 1098. *Stern & Greshman "Supreme Court Practice* (2d Ed) p. 12, 130.

APPENDIX "A"

Internal Revenue Code, 26 U.S.C.

Section 704. Partner's distributive share

"(a) *Effect of partnership agreement.* — A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, be determined by the partnership agreement.

* * *

(c) *Contributed property.* —

(1) General rule. — In determining a partner's distributive share of items described in section 702(a), depreciation, depletion, or gain or loss with respect to property contributed to the partnership by a partner shall, except to the extent otherwise provided in paragraph (2) or (3), be allocated among the partners in the same manner as if such property had been purchased by the partnership.

* * *

(3) Undivided interests. — If the partnership agreement does not provide otherwise, depreciation, depletion, or gain or loss with respect to undivided interests in property contributed to a partnership shall be determined as though such undivided interests had not been contributed to the partnership. This paragraph shall apply only if all the partners had undivided interests in such property prior to contribution and their interests in the capital and profits of the part-

nership corresponds with such undivided interests."

Section 721. Nonrecognition of gain or loss on contribution

"No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership. Aug. 16, 1954, 9:45 a.m., E.D.T., c. 736, 68 A Stat. 245."

Section 731. Extent of recognition of gain or loss on distribution

"(a) *Partners.* — In the case of a distribution by a partnership to a partner —

(1) gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, and

* * *

Any gain or loss recognized under this sub-section shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner.

(b) *Partnerships.* — No gain or loss shall be recognized to a partnership on a distribution to a partner of property, including money."

Section 761. Terms defined

"(a) *Partnership.* — For purposes of this subtitle, the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organi-

zation through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate . . .

* * *

(d) *Liquidation of a partner's interest.* — For purposes of this subchapter, the term "liquidation of a partner's interest" means the termination of a partner's entire interest in a partnership by means of a distribution or a series of distributions, to the partner by the partnership. Aug. 16, 1954, 9:45 a.m., E.D.T., c. 736, 68A Stat. 252."

Section 351. Transfer to corporation controlled by transferor

"(a) *General rule.* — No gain or loss shall be recognized if the property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property."

Income Tax Regulations

Section 1.721-1 Nonrecognition of gain or loss on contribution.

"(b)(1) Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at the

formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61 . . ."

Section 1.731-1 Extent of recognition of gain or loss on distribution

"(a) *Recognition of gain or loss to partner* — (1) Recognition of gain . . . No gain shall be recognized to a distributee partner with respect to a distribution of property (other than money) until he sells or otherwise disposes of such property, except to the extent otherwise provided by section 736 (relating to payments to a retiring partner or a deceased partner's successor in interest) and section 751 (relating to unrealized receivables and inventory items), . . .

* * *

(3) Character of gain or loss. Gain or loss recognized under section 731(a) on a distribution is considered gain or loss from the sale or exchange of the partnership interest of the distributee partner, that is, capital gain or loss."

Legislative History of 1954 I.R.C.

House Rep. No. 1337, 1954 U.S. Code Congressional and Administrative News, p. 4025:

"In addition to the rearrangement, however, your committee has made many substantive changes in

the Code. In general, the purpose of these changes has been to remove inequities, to end harassment of the taxpayer and to reduce tax barriers to future expansion of production and employment.

The restrictive effects of the present tax law on economic growth have been obscured and somewhat offset during the past decade by the inflationary pressures of the war and postwar periods. It is now apparent that prompt adoption of this new tax law is especially timely in order to create an environment in which normal incentives can operate to maintain normal economic growth."

Conference Rep. No. 2543, 1954 U.S. Code Congressional and Administrative News, p. 5319, 5320:

"1. *Summary of major Senate changes accepted by managers on the part of the House.*

(a) Aggregate rule for contributed property (Sec. 704). — Under present law there is considerable doubt as to the determination of partners' respective shares of partnership gain, loss, depreciation, or depletion with respect to property contributed to the partnership by one of the partners. The House bill, adopting the so-called "entity approach", stated that such items are to be shared by the partners in accordance with the partnership agreement for sharing gain or loss generally.

The Senate amendment adopts the House provision as a general rule, but permits the partners, by agreement, to divide the gain or loss, depreciation, or depletion with respect to contributed property among the partners in a manner which attributes

pre-contribution appreciation or depreciation in value to the contributor . . .

* * *

(e) Distributions (secs. 731-735) — The House bill provided that in the case of distributions, whether or not in complete liquidation of a partner's interest, the distributed property was in general to have a basis to the distributee equal to its basis to the partnership, and that gain or loss was to be recognized on the difference between the basis of the distributed property and that of the distributee's partnership interest. The Senate amendment retains the use of the carryover basis for nonliquidating distributions, but provides in the case of liquidating distributions that the distributee's basis for the property received is to be equal to the basis of his partnership interest less any money received . . ."

APPENDIX "B"

OPINION OF U.S. DISTRICT COURT WESTERN DISTRICT OF LOUISIANA

MEMORANDUM OPINION

This action is brought to recover income taxes assessed, and paid under protest, together with statutory interest, from the Government.[1]

In substance, the complaint alleges that the Internal Revenue Service erroneously assessed and collected additional federal income taxes (and interest) from plaintiffs, William D. Frazell and his wife, for the year 1955, in the amounts of $32,084.90 from each plaintiff. Plaintiffs pray for judgment in these amounts plus interest against the United States.

Although the facts are relatively undisputed, the case having been submitted on the pleadings and evidence adduced without trial on the merits, the parties disagree over the legal consequences flowing therefrom. The facts are:

Frazell is a geologist by occupation, having been graduated with a Bachelor of Science degree in Geology from Southern Methodist University in 1934, and a Master of Arts degree in Geology from the University of Texas in

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1. The action is brought pursuant to 28 U.S.C.A. § 1346(a)(1) and § 1402(a)(1).

1935. Following graduation, he was employed by Union Producing Company as a geologist and continued in that position until 1949, when he became associated with W. C. Woolf and N. H. Wheless in a speculative oil venture, the legal nature of which is seriously disputed by the parties. The Government maintains that plaintiff was merely "employed" by Woolf and Wheless, while Frazell contends that he was a principal to a "joint venture" among the three. Both parties point to the written agreement setting forth the relationships among Woolf, Wheless and Frazell in support of their respective positions.[2]

The essence of the agreement was that Frazell would combine his technical skill and geological information with capital supplied one half by Woolf and one half by Wheless for the purchase and development of oil, gas and mineral leases in Texas and any other areas designated by Woolf and Wheless during the life of the contract. Frazell, upon discovering likely mineral producing acreage, was to secure contracts for the acquisition of leases or other mineral rights, and submit them to Woolf and Wheless for their approval, whereupon the interests would be acquired by Frazell, one half in the name of Wheless and one half in the name of Woolf.

Frazell's findings and recommendations would not obligate Wheless and/or Woolf and upon either or both of the latter declining to acquire the interests, Frazell would be allowed to make other arrangements for his own ac-

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2. The entire agreement is hereinafter set forth as an appendix to this opinion.

quisition or acquisition by a third party only with the written consent of Wheless and Woolf. Any interests acquired by Wheless and Woolf in which Frazell did not desire an interest would not relate to plaintiff's participation under the agreement.

Frazell agreed to a monthly salary or drawing account of $675.00, plus expenses, in return for his full-time efforts in discovering and securing potentially profitable mineral properties or interests for future development. Presumably to give Frazell added incentive, Woolf and Wheless provided for limited participation by him in the profits resulting from development of the leases which he secured. Frazell's interest would arise according to the agreement only after Wheless and Woolf had recovered their full costs and expenses on the properties. All property and leases acquired by Frazell were to be held under record ownership of Wheless and Woolf who, together, retained at least nominal control and management over the properties.

After recovery of expenses and costs by Wheless and Woolf, Frazell, upon written request, was to be assigned his specified interest in the properties and thereafter be entitled to the portion of production allocated to his interest. His interest was subject, however, to its proportionate share of future costs for developing, operating producing, transporting and marketing the production from the properties, plus a "reasonable charge" for overhead costs and expenses. Any outstanding indebtedness against the properties would be charged *pro rata* against Frazell's share of production from the properties.

The agreement further provided that, should Wheless and Woolf dispose of the properties and, after recovering costs and expenses, realize a profit therefrom, Frazell would be entitled to his proportionate share therein. Prior to assignment of his interest in any property to him, Frazell was prohibited by the terms of the agreement from disposing of his rights arising under the agreement. After being assigned his interest, Frazell, prior to disposing of all or any part of his interest, was obligated to grant Woolf and Wheless what amounted to a "first option" on the purchase thereof.

His participation was limited to those leases and interests acquired through his efforts under the provisions of the agreement, which, upon thirty days' notice by any party, was subject to termination.

The combined efforts of Frazell, Wheless and Woolf under this agreement proved profitable. From February 9, 1951, through March 31, 1955, Wheless and Woolf advanced capital in the sum of $1,245,106.00 and recovered from oil and gas production on the properties the sum of $1,008,613.00, thus leaving an unrecovered balance in the sum of $236,493.00. In the period beginning January 1, 1955, and ending January 1, 1956, the properties produced an average net monthly income of $29,326.00. Because no further expenditures for development were required, Frazell, Wheless and Woolf expected the properties to be "paid out" by November 30, 1955.

The parties to this agreement decided, at this time, to organize a corporation for the purpose of continuing their

mutually profitable association in oil and gas ventures. Accordingly, on March 21, 1955, Frazell, Wheless and Woolf organized the W. W. F. Oil Corporation under the laws of Delaware. All properties acquired through the efforts of Frazell under the agreement were transferred to the corporation and each party received shares of stock in the corporation proportionate to his respective interest in the properties. Wheless (N. H. Wheless Oil Company) received 21,750 shares, Woolf received 21,750 shares, and Frazell received 6,500 shares (13% of the aggregate 50,000 shares). In addition, Frazell was elected president of the W. W. F. Oil Corporation at an annual salary of $16,000. Woolf and Wheless were elected Vice Presidents.

In filing their federal income tax returns for the year 1955, plaintiffs treated their receipts of the 6,500 shares of stock in the W. W. F. Oil Corporation as a tax-free exchange of property for stock under Section 351(a) of the Internal Revenue Code of 1954.[3]

Subsequently, the District Director made an additional assessment against each plaintiff in the amount of $26,364.54 (additional federal income taxes for the period from January 1, 1955, through December 31, 1955) and

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3. Section 351(a) of the Internal Revenue Code of 1954, 26 U.S.C.A. § 351(a), provides, in pertinent part:

"(a) General rule.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property."

$5,720.36 (interest), or an aggregate demand for $32,084.-90 against each plaintiff.

In the Director's "Explanation of Items Changed," he reasoned that, under the original agreement among Wheless, Woolf and Frazell, the interest possessed by Frazell was only a "contingent interest," of such a nature that the taxpayer would not be considered as "owning" an interest in the properties until the "payout" was accomplished. Therefore, he reasoned, when the properties were transferred to the W. W. F. Oil Corporation prior to "payout", the taxpayers were not in a position to exchange "property" for the 6,500 shares of no par value stock they received because their "contingent interest" amounted only to "* * * a promise to receive an interest in the properties, if and when, payout was accomplished." Section 351(a) of the Code allows for a tax-free exchange of property for stock but since the taxpayers did not "own" an interest in the properties, according to the Director's position, the taxpayers had no "property" within the meaning of that Section which they could transfer in exchange for the 6,500 shares of stock in the W. W. F. Oil Corporation. Accordingly, the stock thus received by taxpayers was treated, for tax purposes, as additional compensation for services rendered by Frazell in his capacity as a geologist, and taxed accordingly under the provisions of Section 61(a)(1) of the Internal Revenue Code of 1954. The Engineer Revenue Agent set the fair market value of the stock at $14.00 per share and the resulting value of the stock received by Frazell was set at $91,000.00. This

amount was returned to income under Section 61(a)(1) for the year 1955.

The parties have jointly stipulated that the ultimate issue to be resolved is whether the Commissioner correctly included the $91,000.00 in Frazell's gross income for the taxable year 1955. They further agreed that, should judgment for plaintiffs in any amount be rendered, the Internal Revenue Service shall compute the resulting tax consequences subject to review by plaintiffs.

Plaintiffs' position is that Frazell, after working for Union Producing Company for fourteen years, decided to forego his fixed salary in order to embark on a joint venture with Wheless and Woolf, thereby combining his geological information and professional training with capital supplied by Wheless and Woolf. As noted above, from February 9, 1951, through March 31, 1955, Wheless and Woolf advanced capital in the sum of $1,245,106.00 but recovered from oil and gas production the sum of $1,008,613.00. During this same period, Frazell supplied to the venture a very valuable oil map which was his private property, as well as his professional information, knowledge and skill in furtherance of the joint efforts of the parties, and in addition to a growing interest in the properties, received a monthly salary or drawing account of $675.00 (later increased to $833.00 from September 1 1953, through March 31, 1955).

Because from January 1, 1955, through January 1, 1956, the average net monthly income (less operating expenses) from the properties subject to the agreement was

$25,326.00 and the parties expected the properties to be "paid out" in eight months following March 31, 1955, Frazell approached Wheless and Woolf with the suggestion that the joint venture be terminated so as to allow Frazell to partially "cash in" on the fruits of the venture.

Wheless countered Frazell with a proposal that the parties form a corporation, transfer the properties subject to the joint-venture agreement to that corporation, and issue capital stock to each party in proportion to his respective interests in the properties. Subsequently, the W. W. F. Oil Corporation was formed and Frazell was issued the 6,500 shares of stock.

Although the properties had not fully "paid out" at the time of their transfer from the joint venture to the corporation, Frazell argues that he had a so-called "carried interest" in the properties which meets the definition of "property" as set forth in Section 351(a) of the Code.

Defendant contends however, that the agreement of February 9, 1951, is merely a contract of employment whereby Wheless and Woolf agreed to employ Frazell for a fixed salary of $675.00 per month with additional compensation for services rendered in the event Frazell's efforts proved profitable and all costs and expenses were recovered by Wheless and Woolf. It contends that the receipt of 6,500 shares of no par value stock in the subsequently formed W. W. F. Oil Corporation was merely additional compensation for geological services rendered and was thus correctly included in plaintiffs' gross in-

come for the year 1955, the year when the additional compensation was received.

Defendant points specifically to what it contends was rigid control and management power vested in the employers, Wheless and Woolf; Frazell's fixed monthly salary of $675.00 (later changed to $833.33); the total absence of any risk assumed by Frazell; the lack of any capital investment by Frazell in the enterprise; the absence of profit-sharing between Frazell and the other principals to the agreement; the retention of title by Wheless and Woolf to all properties acquired by Frazell pursuant to the agreement; and the absence of an intent to form a joint venture or partnership as evidenced by the clear and unambiguous language of the agreement of February 9, 1951. Even if it is conceded that Frazell's interest in the properties was a "property" right, argues the defendant, under the employment agreement the receipt of 6,500 shares would still constitute additional compensation for services rendered and, accordingly, would be included in gross income for tax purposes.

We are convinced, however, that plaintiffs have proved by a preponderance of the evidence that the exchange of their interest in the oil and gas properties subject to the February 9, 1951 agreement for the 6,500 shares of stock was a tax-free exchange of property for stock as contemplated by Section 351(a). Before entering upon an analysis of the basic principles governing joint ventures it is noted that the Louisiana jurisprudence on this subject is not unlike that in a majority of other American juris-

dictions.[4] See, generally O'Neal, *An Appraisal of the Louisiana Law of Partnership*, 9 La. L. Rev. 307, *et seq.* (1949).

In Louisiana a joint venture results from an undertaking by two or more persons to combine their property, capital, labor or skill or any combination of these elements in the conduct of a particular line of trade or general business, for joint profit, thus creating the status of a partnership, although the facts may not show a formal partnership. See *Ault & Wiborg Co. of Canada v. Carson Carbon Co.*, 160 So. 298 (La. Sup. Ct., 1935), and *Daily States Pub. Co. v. Uhalt*, 126 So. 228 (La. Sup. Ct. 1930). In this respect, joint ventures are likened to partnerships and are governed generally by the same rules. *Ludeau v. Avoyelles Cotton Co., Inc.*, 113 So. 846 (La. Sup. Ct., 1927), and *Fossier v. American Printing Co., Ltd.*, 130 So. 2d 529 (La. App., 4th Cir., 1961); La. Civil Code Arts. 2801-2890.

The status of a partnership is defined as a "* * * synallagmatic and commutative contract made between two or more persons for the mutual participation in the profits which may accrue from property, credit, skill or industry, furnished in determined proportions by the parties." La. Civil Code art. 2801. Thus a partnership or joint venture may be founded on contributions of capital by one party, and contributions of skill, time or labor by

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4. In a suit for refund of federal income taxes allegedly wrongfully assessed and collected, a determination of a joint venture necessitates application of State law. See *United States v. Ogilvie Hardware Co.*, 330 U. S. 709 (1946); *Flanders v. United States*, 172 F. Supp. 935 (N.D. Calif. 1959); and *Tate v. Knox*, 131 F. Supp. 514 (Minn., 1955).

the other. La. Civil Code Art. 2809 and *Succession of Melancon*, 119 So. 28 (La. Sup. Ct., 1928). Both the joint venture and the partnership must ultimately rest upon a contract, express or implied, between the parties who must, as between themselves, have intended to form a partnership or joint venture. La. Civil Code art. 2805, *Glover v. Mayer*, 25 So. 2d 242 (La. Sup. Ct., 1946); *Williams v. Ralph R. Miller Shows*, 15 So. 2d 249 (La. App., 1st Cir., 1943); *Porter v. Cooke*, 127 F. 2d 853 (5th Cir., 1942); and *Shushan Bros v. Drennan & Hillcoat*, 104 So. 214 (La. Sup. Ct., 1924).

A sharing in the profits of the enterprise is essential to the relationship of joint venture or partnership as is the sharing of control or management of the affairs of the enterprise. La. Civil Code art. 2811; *Yearwood v. United States*, 55 F. Supp. 295 (W. D. La., 1944); *Hawkins v. Travelers Indm. Co.*, 73 So. 2d 348 (La. App., 2d Cir., 1954); and *Pillsbury Mills, Inc. v. Shehardy*, 90 So. 2d 797 (La. Sup. Ct., 1956). A provision for recoupment by a partner or joint venture of capital advances before a dividend of profits is declared does nct affect the partnership or joint venture relationship. *Fossier v. American Printing Co., Ltd., supra*, and authorities cited therein.

Although joint ventures are often limited to a single business transaction, they sometimes characterize a business enterprise lasting over several years *Emerson v. Shirley*, 175 So. 909 (La. Sup. Ct., 1937). A majority of other jurisdictions look to loss-sharing as an essential element of partnership or joint venture, but Louisiana Courts have held that partners may contract for the risk of loss

to be assumed by one or more of the partners exclusively. *Sheridan v. LeQuire*, 15 So. 2d 118 (La. App., 1st Cir., 1943); *Pollard v. Browder*, 126 So. 2d 310 (Fla. App., 1961); and O'Neal, *An Appraisal of the Louisiana Law of Partnership*, 9 La. L. Rev. 307, 321 (1949). Likewise, the parties may agree that the administration of the partnership or joint venture will be entrusted to one or more of the partners or joint venturers exclusively. La. Civil Code arts. 2867, 2868, 2869 and 2870; *Comment, The Business Joint Venture in Louisiana*, 25 Tulane L.Rev. 382, 386, 387 (1951); O'Neal, *An Appraisal of the Louisiana Law of Partnership*, 9 La. L. Rev. 307, 359 (1949); *Barnett v. Ludeau*, 129 So. 655 (La. Sup. Ct., 1930); *Shell Oil Co. v. Prestidge*, 249 F. 2d 413 (9th Cir., 1957); *Landreth v. United States*, 70 F. Supp. 991 (N.D. Texas, 1946).

Defendant, in striking at the very basis of the alleged joint venture agreement, that is, the contract itself, strenuously contends that the agreement between Frazell, Wheless and Woolf patently evidences a contract of employment from the terms of the instrument itself, pointing to language, for example, to the effect that "* * * Wheless and Woolf, jointly, as is hereinafter set forth, have and do hereby employ Frazell at their joint expense and on the following terms and conditions, * * *." References are also made in the contract to Frazell's "employment," his "monthly salary or drawing account," and the retention of powers of management and control in Wheless and Woolf.

In general, the legal relationship of the parties will not be conclusively controlled by the mere terms which the parties use to designate the relationship although the

terms and language of the agreement are strong evidence tending to show that the relation actually existing conforms to the terms used by the parties. See annotation at 137 A.L.R. 6, 86, *et seq.* The ultimate criterion is whether the parties actually intended to enter into a joint venture and, in arriving at this determination, there are no hard and fast rules fixing the legal requisites. Each case must be considered *sui generis* and care must be exercised that consideration is given to the usages and practices characteristic of the particular commercial undertaking sought to be labeled a "joint venture." *Hero & Co. v. Farnsworth & Chambers Co., Inc.*, 107 So. 2d 650 (La. Sup. Ct., 1958), and *Pillsbury Mills, Inc., v. Shehardy, supra.*

We must look to the totality of evidence and not just the written agreement between the parties, to determine whether a joint venture was entered into. See *Flanders v. United States*, 172 F. Supp. 935 (N.D. Calif., 1959). As stated by the Fifth Circuit Court of Appeals in *Haley v. Commissioner of Internal Revenue*, 203 F. 2d 815, 818 (5th Cir., 1953), even though it is expressly stated in the written agreement that the parties do not intend to enter into a joint venture or partnership, "* * * if the agreements and the conduct of the parties thereunder plainly show the existence of such relationship, and the intent to enter into it, it will nevertheless be held to exist for tax purposes." To the same effect is *Universal Sales Corp. v. Calif. Press Mfg. Co.*, 128 P. 2d 665 (Calif. Sup. Ct., 1942), and authorities cited therein.

Although the agreement of February 9, 1951, does contain some language indicative of an employer-employee relationship, the subsequent agreement among the identical parties which terminated the agreement of February 9, 1951, referred to the latter as a "joint venture agreement." In that agreement, Frazell agreed to transfer all of his interests in the properties acquired under the February 9, 1951, agreement to the W. W. F. Oil Corporation in return for 13% of the total 50,000 shares of stock in the corporation. Significantly, this reference to the first agreement as a "joint venture agreement" was made at an unsuspicious time, that is, long prior to the filing of federal income tax returns for the year 1955 and the later assessment by the Commissioner.

Looking to what the Louisiana Courts describe as "the usage and practices characteristic of the particular commercial undertaking sought to be labeled a "joint venture," we have found, through our own research, several cases involving oil deals wherein similar contracts were interpreted and adjudged to be joint venture agreements.

In *Kasishke v. Baker*, 146 F.2d 113 (10th Cir., 1944), a case which we believe correctly sets forth the principles applicable here, the plaintiff, Baker, entered into a verbal agreement with defendant, Kasishke, which provided in substance that, in order to engage in the oil business, Kasishke would advance all of the necessary capital and render some personal services while Baker would contribute his entire time in exchange for a nominal salary plus ten per cent of the profits. It was further agreed that after Kasishke recovered his capital expendi-

tures, Baker would have a ten per cent interest in the properties. The Coralena Oil Company was organized by Kasishke and title to all the oil properties was taken in the name of the corporation. Forty-four shares of stock in the corporation were issued to Baker and his wife, and the balance were issued to Kasishke and his wife. Subsequently, the Olive Drilling Company was organized to drill wells for Coralena. The stock in this company was likewise held by Kasishke and his wife, except for one share issued to Baker to qualify him to serve on the board of directors. The oil venture was successful. The oil leases acquired became valuable and the properties began to "pay out", and in several years the properties were worth approximately $6,000,000. Personal disagreements caused Baker and Kasishke to become estranged and Baker then brought suit for an accounting of the oil properties, alleging that, as a joint venturer with Kasishke, he was entitled to a one-tenth interest in the properties. Kasishke argued, however, as defendant does here, that Baker's interest in the properties was contingent and would arise only after the money advanced by Kasishke had been repaid and the properties had "paid out." Because those contingencies had not occurred, argued Kasishke, Baker could not share in the profits nor in the properties. In rejecting these contentions, the Court stated that although Baker's right to receive a return (in addition to his nominal salary) on his interest in the properties was contingent upon the properties "paying out" and recovery of the capital expenditures by Kasishke, Baker's interest in the properties vested from the moment the contract was entered into

and did not depend, for its existence, upon any contingencies. Continuing, the Court said:

> "* * * At the outset, Kasishke furnished approximately $300,000. This was his main contribution to the business [which continued for approximately seven years]. Baker devoted all his time and energy to the management of the joint enterprise for which he received only a nominal salary. At the end of this time the properties had a value of approximately $6,000,000. We agree with the conclusions of the court that Baker's interest attached from the date of the contract, and that the profits were earned and only his right to receive returns was postponed until the conditions were fulfilled."

Particularly significant for purposes of analyzing this agreement is the following language from the Court's opinion:

> "It is urged that the arrangement did not constitute a joint adventure. It is argued that this follows from the facts that Baker's interest was dependent upon the contingencies already noted; that there was no agreement to share the losses; that there was no equal right of management; that there was no joint interest in the property; that the contract was terminable at the will of either party; and that the enterprise was not limited to a specific venture.
>
> "It is impossible to define the relationship of joint adventure with exactitude and precision. In many respects it is analogous to a partnership, the main difference being that a joint adventure is more limited in its scope of operations than a partner-

> ship. In the main, some of the relevant factors of a joint adventure are that there must be joint interest in the property; there must be an agreement, express or implied, to share in the profits and losses from the venture; there must be action and conduct showing co-operation in the property. It has been held that it is not absolutely necessary that there be participation in both profits and losses. In determining whether one shares in the losses, the fact that one works for a nominal salary, thus losing a part of the value of his services, will be taken into account. * * *"

Concluding, the Court held that although the title to properties was held in the name of the corporations, it was in fact the property of Baker and Kasishke, and the corporations were merely acting as trustees for them.

In a companion case, *Kasishke v. Keppler*, 158 F. 2d 809 (10th Cir., 1947), the plaintiff, a geologist, brought suit against the same defendant to recover a 1/16th interest in certain oil properties and for an accounting. The plaintiff had entered into an oral contract with Kasishke whereby the plaintiff, as a skilled geologist, was to locate and recommend potential oil and gas producing properties to Kasishke for his approval. Upon Kasishke's approval, the properties were to be acquired and developed at Kasishke's expense, subject, however, to a recovery of expenses from development. For his services, Keppler was to receive $300 a month and 1/16th interest in the properties acquired after Kasishke had been reimbursed. The District Court found that Keppler was an experienced, qualified geologist and that at the time of the contract

was capable of earning much more than the stipulated salary; that after the execution of the contract, Keppler devoted himself entirely to his duties, and that several blocks of leases had been acquired by Kasishke upon the recommendation of Keppler. The District Court held that the agreement between Keppler and Kasishke created a joint venture as a matter of law and that a constructive trust arose when Kasishke took the leases in his own name and when he refused to recognize Keppler's interest. Affirming the District Court's decision, the Court of Appeals held that the agreement between Keppler and Kasishke was indistinguishable from that between Baker and Kasishke (see *Kasishke v. Baker, supra)* and was, as a matter of law, a joint venture agreement.

We regard these two cases as indistinguishable in principle from the facts here. Particularly in *Kasishke v. Keppler*, aside from the fact that no written contract was involved there, the relationship between the geologist and the promoter was substantially the same as the relationship here between Wheless, Woolf, and Frazell. As explained in *Kasishke v. Baker*, the fact that one works for a nominal salary, thus losing a part of the value of his services, will be taken into account. See, also, *Seymour v. Wilden*, 137 F. 2d 160 (10th Cir., 1943), and *Potucek v. Blair*, 270 P. 2d 240 (Kans. Sup. Ct., 1954).

In *Potucek v. Blair, supra*, the plaintiff, an experienced manager of independent oil companies, alleged that the defendant, an oil operator, became interested in his talents and engaged him in a joint venture for the acquisition and development of oil and gas properties; that the

parties agreed for all properties to be held in defendant's name until such time as he was reimbursed for all monies advanced by him for acquisition and development of the properties; that plaintiff was to receive an interest ranging from 1/8th to 1/4th in all properties acquired; that at some later date the parties would reduce their agreement to writing and after the defendant recovered all capital advanced, plaintiff would be assigned his specified interests in the properties; that, prior to assignment of his specified interests, plaintiff would draw a monthly salary of $375.00 (a smaller salary than he could have obtained elsewhere); and that, after defendant had breached the agreement and sold the properties, plaintiff received a "notice of termination of employment" but did not receive a portion of the proceeds of the sale.

Plaintiff, suing for specific performance of the oral contract, prayed for a determination that his agreement with defendant was for a joint venture and that he was therefore entitled to his specified interest in the proceeds from the sale of the properties. The Supreme Court of Kansas held that plaintiff had stated a cause of action for relief on the theory of joint venture as distinguished from an employment contract. Pointing to plaintiff's contribution to the joint venture, the Court said: "Surely the acceptance by appellant of appellee's services for a period of years constitutes a valid consideration. Such services were as vital to the success of the venture as appellant's contributions of the physical properties or other capital." 270 P. 2d at 245. Further, the Court noted that receipt of a nominal salary under the agreement constituted a real

consideration to support the agreement. Citing *Kasishke v. Baker*, *supra*, the Court said that, although plaintiff's right to receive profits was postponed until the conditions were fulfilled, plaintiff's interest attached, at the time the oral agreement was made, to all leasehold interests the defendant then owned and to all others when they were procured.

For other examples of usages and practices characteristic of joint ventures in the oil industry, see *Grannell v. Wakefield*, 242 P. 2d 1075 (Kans. Sup. Ct., 1952); *Catlett v. Jordan*, 244 P. 2d 564 (Okla. Sup. Ct., 1952); *Emerson v. Shirley*, 175 So. 909 (La. Sup. Ct., 1937); *Shoemake v. Davis*, 78 P. 2d 1043 (Kans. Sup. Ct., 1937). See, also, *Kleinschmidt v. United States*, 146 F. Supp. 253 (Mass., 1956) (patent engineer held joint venturer); *Stricker v. Morgan*, 158 F. Supp. 830 (S.D. Miss., 1958) aff. 268 F. 2d 882 (5th Cir., 1958) (timber and land deal); *Greenbaum v. Kirkpatrick*, 129 F. Supp. 648 (W. D. Okla., 1955); and *Flitch v. Boyle*, 78 P. 2d 9 (Kans. Sup. Ct., 1938).

As we have said already, a joint venture must rest upon joint contribution of capital, skill, time or labor by the parties thereto. La. Civil Code art. 2809, *Succession of Melancon*, *supra*. Here Wheless and Woolf principally contributed their capital, whereas Frazell principally contributed his knowledge and experience as a geologist, his skill and information in the field, and devoted all of his time to the joint efforts of the parties in discovering and securing profitable oil, gas and mineral leases and interests. Frazell contributed most substantially

to the enterprise by supplying geologic maps which, prior to entering into the agreement with Wheless and Woolf, were exclusively his own private property. Frazell stated on deposition that, from information contained in his maps, the W. W. F. Oil Corporation drilled 36 wells in the described areas and was successful in producing oil and gas from 27 of them. Only 9 resulted in dry holes. In the areas described by Frazell's maps, "considerable" royalty was purchased and a gasoline plant was built. The parties also instituted secondary recovery operations and accomplished "water flooding." Frazell testified undisputedly that his map which described the western section of Coleman County, Texas, was the basis of acquisitions and production which amounted to one-half of the total income and producton enjoyed during the life of the agreement. Moreover, the fact that Frazell worked for a smaller salary or expense allowance than he could have obtained elsewhere, thus losing a substantial part of the value of his services, must be considered as a contribution to the enterprise. See *Kasishke v. Baker, supra; Seymour v. Wilden, supra;* and *Potucek v. Blair, supra.*

Defendant argues, however, that the monthly compensation received by Frazell was a "salary" and therefore indicative of an employer-employee relationship. To the contrary and as explained by Wheless on oral deposition: "He had a drawing account; he was not to receive any compensation as salary; he was to get his entire profit out of this proposition by the results of the operation, but he had a drawing account, which was figured on the basis of what he thought and what we agreed would

be a reasonable amount of living expenses for himself and his family." Although Frazell was not obligated to repay the amount he received monthly in the event the operations were not successful he did subject himself to the risk of losing his time, efforts, skill, knowledge, and geologic information. In other words, Frazell stood to lose these things, valuable things, whereas Wheless and Woolf stood to lose their capital investments and the limited time they devoted to the enterprises.

In *Summers v. Hoffman*, 69 N. W. 2d 198 (Mich. Sup. Ct., 1955), 48 A.L.R. 2d 1033, the Supreme Court of Michigan stated in a similar joint venture context: Both made a contribution: plaintiff contributed his time, skill and supervision, while defendant contributed the capital. * * * But defendants claim that under the agreement plaintiff would not share any losses or bear the risk of loss in case of an adverse decision in the suit involving the title to the property. With this contention we cannot agree. *'Loss' does not necessarily mean actual 'monetary loss.'* If the land was eventually sold at a loss the result would be that *plaintiff's expenditure of time would have been for nought as would defendants' monetary investment.* If the title litigation had been decided adversely then plaintiff would have lost large out-of-pocket expenses and the value of the time which he had theretofore spent on the project which, while not quite as concrete or measurable as defendants' cash investment, is nevertheless a loss. It cannot be said that the plaintiff did not share any risk of loss, * * *." (Emphasis added.) Likewise here, Frazell stood the risk of losing his time and efforts for which he had

received only nominal compensation prior to the success of the venture, whereas Wheless and Woolf stood to lose their capital investments. See *Sample v. Romine*, 8 So. 2d 257, 9 So. 2d 643, 10 So. 2d 346 (Miss. Sup. Ct., 1942).

Defendant contends that Frazell did not participate in the management and control of the enterprise and that sole authority was vested in Wheless and Woolf under the agreement. Notwithstanding the rule that management and control of a joint venture may, under Louisiana law, be entrusted to one or more of the joint venturers exclusively, the evidence and depositions fail to bear out defendant's contentions. La. Civil Code arts. 2867-2870; *Comment, The Business Joint Venture in Louisiana*, 25 Tulane L. Rev. 382, 386, 387 (1951); O'Neal, *An Appraisal of the Louisiana Law of Partnership*, 9 La. L. Rev. 307, 359 (1949); *Barnett v. Ludeau, supra; Shell Oil Co. v. Prestidge, supra;* and *Landreth v. United States, supra.* Explaining the extent of Frazell's authority and managerial descretion in performing his part of the venture, Wheless stated on oral deposition:

> "A. Actually, Mr. Frazell had quite a lot of authority and jurisdiction in this situation; to start out with, I think he used to refer practically everything back over here to us; however, even in the beginning, my recollection is that he had a $10,000.00 bank account subject to his check withdrawal, disbursements, and he had authority to spend up to $5,000.00 in any one transaction without referring it to this office, but that anything over and above that in any one transaction, well, he was supposed to take it up with us and get authority for expenditures. Right

at first, I think, perhaps he didn't use that $5,000.00 margin of authority that he had, but later on, why, we probably extended the $5,000.00 and we just would leave the thing more or less up to him because, actually, that was what we had in mind when we went in and got Dick to do this thing. We were sitting over here in Shreveport and Abilene, Texas was 400 miles away over there, and he was on the ground and on the job and, practically speaking, we very much preferred for him to run it than to come to us.

"A. He could use that $5,000.00 to — he could spend up to $5,000.00 on any one transaction without referring it to us.

"Q. Yet, at the same time now, both you and Mr. Woolf were the only ones who made a decision as to whether or not you would acquire property; you did have that power?

"A. No, sir; he could use that $5,000.00 to acquire property."

An agreement whereby Frazell would submit acquisitions amounting to more than $5,000.00 to Wheless and Woolf for their approval is entirely reasonable in light of the fact that the latter two were supplying the capital for the acquisitions. Being far removed from the actual operation of discovery and acquisition, they understandably desired to retain some measure of control over Frazell's transactions. On the other hand, Frazell was the party making the acquisitions and he presumably would not have negotiated for the leases had he not thought them to be potentially profitable. This in itself was an exercise

of discretion. Moreover, Frazell had complete authority to spend up to $5,000.00 on any one transaction without securing the approval of either Wheless or Woolf. We believe, therefore, that Frazell shared in the management and control of the enterprise to a reasonable extent under the circumstances. The fact that title to the properties was held in the names of Wheless and Woolf matters not for the reasons explained in *Kasishke v. Baker, supra; Kasishke v. Keppler, supra;* and *Potucek v. Blair, supra.* This was merely an arrangement of convenience and form, probably intended to protect Wheless and Woolf and simplify transactions. As between the parties to the agreement, Frazell's interest in the properties existed regardless of where title was placed.

Hypothetically, if Wheless, Frazell and Woolf had expressly agreed on all the typical incidents either of a joint venture or of an employment contract, and would have, in addition, described their relation in the correct legal terms, no question as to the distinction between joint venture and employment would have arisen. As a matter of fact, however, the parties did not expressly regulate all the incidents of their legal relationship, and, moreover, the express provisions of their contract, if considered separately, were typical, some of a joint venture and others of an employment relation. Viewing the agreement as a whole and the conduct of the parties in the light of the usages and practices characteristic of joint ventures in the oil industry, we conclude that the agreement of February 9, 1951, constituted a joint venture as distinguished from a contract of employment. *Haley v. Commissioner,*

supra; and *Hero & Co. v. Farnsworth & Chambers Co., Inc., supra.*

It follows, therefore, that, upon termination of the joint venture between Frazell, Wheless and Woolf and the creation of the W. W. F. Oil Corporation, the transaction whereby Frazell received the shares of stock in the corporation in exchange for his interest in the properties subject to the joint venture agreement constituted a tax-free exchange of "property" for stock within the meaning of Section 351(a).

For these factual reasons, and on the basis of the authorities cited, there will be judgment for plaintiffs as prayed.

A proper decree should be presented.

THUS DONE AND SIGNED, in Chambers, in Shreveport, Louisiana, this the 31st day of January, 1963.

/s/ Ben C. Dawkins, Jr.
United States District Judge

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 20758

UNITED STATES OF AMERICA,
Appellant,

versus

WILLIAM D. FRAZELL and MARTHA T. FRAZELL,
Appellees.

Appeal from the United States District Court for the Western District of Louisiana.

(August 5, 1964.)

Before TUTTLE, Chief Judge, HUTCHESON and GEWIN, Circuit Judges.

TUTTLE, Chief Judge: This is an appeal by the Government from a judgment in favor of the taxpayer. *Frazell v. United States*, W.D. La. 1963, 213 F. Supp. 457. As the largely undisputed facts are set out at length in the opinion of the district court, only a summary will be presented here. On February 9, 1951, William Fra-

zell, a geologist, entered into a contract with the N. H. Wheless Oil Company, a partnership, and W. C. Woolf, under which Frazell was to check certain areas to determine whether potentially productive oil and gas properties might be procured there. He was to recommend those properties he found suitable to Wheless and Woolf, and upon their joint approval, he was to attempt to acquire such properties, taking title thereto in the names of Wheless and Woolf in equal shares. In return for these services, Frazell was to receive "a monthly salary or drawing account," plus expenses, and specified interests in the property acquired. It was agreed, however, "that Frazell shall not be entitled to, nor shall he be considered as owning, any interest in said properties until such time as Wheless and Woolf shall have recovered their full costs and expenses of said properties" including the amounts paid out to Frazell. 213 F. Supp. at 470.

The arrangement proved successful, and it was evident in the early part of 1955 that Wheless and Woolf would fully recover their costs and expenses by the end of November of that year. In April 1955, the 1951 contract was terminated, and by contract dated April 20, 1955, all the properties acquired under the earlier arrangement were transferred to the W.W.F. Corporation, a Delaware corporation formed specifically to acquire these properties in return for the issuance of debentures to Wheless and Woolf and of stock to Wheless, Woolf, and Frazell. Frazell received 6,500 shares of W.W.F. stock (13% of the total issued), having a fair market value

of $91,000.00, but he included no part of this amount in his 1955 income tax return. The Commissioner ruled that the $91,000.00 should have been included in income and assessed a deficiency, which Frazell paid under protest and seeks to recover here.

Frazell contends that he received the W.W.F. stock in a tax-free exchange within the terms of section 351(a), Internal Revenue Code of 1954. That section provides:

> "No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control . . . of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property."

The district court agreed that section 351(a) is applicable in this case. This was said to follow from that court's finding that the 1951 contract created a "joint venture" among the three participants. 213 F. Supp. at 468. We take no issue with the trial court's finding of fact in this matter, but it does not follow from the categorization of the 1951 arrangement as a "joint venture" that the April 1955 transactions resulted in no taxable income to Frazell.

It is fundamental that "compensation for services" it taxable as ordinary income under the Internal Revenue Code of 1954. I.R.C. 1954 § 61(a)(1). This principle

applies whether the one compensated for his services is an employee receiving a salary, fees, or commission *(ibid.)*, one receiving corporate securities (I.R.C. 1954 § 351(a)), or a "service partner" receiving an interest in the partnership, (I.R.C. 1954 § 721; Treas. Reg. § 1.271-1 (b)(1).

The regulation pertaining to partnerships provides that

> "the value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61. The amount of such income is the fair market value of the interest in capital so transferred . . . at the time the transfer is made for past services. . . . The time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest."

This rule would have been directly applicable had the 1951 contract continued in effect through November 1955, the date on which Wheless and Woolf would have fully recovered their costs in the venture. The contract made it clear that Frazell would "not have the right to dispose of any rights which may accrue to him before those costs were recovered." 213 F. Supp. at 472. But after November, he would have received a largely unrestricted[1]

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1 Even after Wheless and Woolf recovered their costs, the contract gave them a right of first refusal should Frazell desire to dispose of any of his interests in the properties in question.

interest in about 13% of the partnership properties. That this interest was primarily, if not entirely, in return for Frazell's services to the enterprise is undisputed. Thus, so much of the interest Frazell was to receive in November of 1955 as could be attributed to his services for the oil venture would have been ordinary income to him in the year of receipt.

The applicable rule is in no way changed by Frazell's contention that his interest in the enterprise was a "carried interest." There are three recognized varieties of "carried interest," and each "may be created under varied circumstances, *e. g.*, . . . as compensation for services rendered, *e.g.*, by a geologist. . . ." Williams & Meyers, Oil and Gas Law, vol. 2, § 424 (1959). The interest created by the 1951 contract most nearly fits into the "Menahan" category of "carried interests;" that is, "a springing executory interest . . . conveyed by the carrying party [Wheless and Woolf] to the carried party [Frazell], such interest to become possessory upon the satisfaction of . . . [the carrying party's] costs." Williams and Meyers, op. cit. *supra* § 424.1, p. 423. Even if Frazell is taken to have had some sort of interest in the properties in question from their first acquisition, his interest would not have become possessory until November 1955. Under Treasury Regulation § 1.721-1 (b) (1), the value of that interest would have been taxable to him at that time. See also Anderson & Coffee, "Proposed Revision of Partner and Partnership Taxation: Analysis of the Report of the Advisory Group on Subchapter K," 15 Tax L. Rev. 285, 318 (1960).

The fact that the contract was terminated prior to November 1955 should have no effect on the tax consequences of Frazell's arrangements. The transactions of April 1955 may be viewed in either of two ways: (1) If Frazell's partnership interest became possessory immediately upon the termination of the 1951 contract, so much of that interest received as compensation for services was taxable to him under the rule of Treasury Regulation § 1.721 (b) (1). Thereafter, the transfer of his interest for W.W.F. stock was tax-free under section 351(a). (2) If the $91,000.00 of W.W.F. stock was given in substitution for the partnership interest originally contemplated, so much of that stock received in compensation for services was taxable to Frazell under section 351(a). As either view of the 1955 transactions results in ordinary income to Frazell there is no reason for us to split hairs and choose between them.

This is not to say that the full $91,000.00 is ordinary income. The trial court found that, just as Wheless and Woolf contributed large amounts of capial, "Frazell supplied to the venture a very valuable oil map which was his private property." 213 F. Supp. at 461. Indeed the record shows that prior to entering into the 1951 contract Frazell had acquired several maps which apparently proved very helpful to the work of the venture. Among the reasons given by Mr. Wheless for desiring to employ Frazell was that "he had accumulated maps, geological data and various information that was valuable to the arrangement that it would have taken a long time for someone

else just moving into the territory to accumulate." And Frazell himself testified that he "had contributed considerable information and maps which resulted in the discovery and production of oil. . . ." Although it is clear that the greater part of the 13% interest received by Frazell was received as compensation for services, the court's finding and the cited testimony suggest that some part of that interest might have been received in return for "property;" namely, the maps. That part of the property Frazell received in 1955 attributable to his contribution of maps is not taxable in 1955 no matter whether we view the interest received as a partnership interest vesting on the termination of the 1951 contract (I.R.C. 1954 §721) or as shares of W.W.F. stock given in substitution therefor. (I.R.C., 1954 § 351(a)). See Treas. Reg. § 1.351-1(2), example 3; Mertens, The Law of Federal Income Taxation, vol. 6, § 35.37, pp. 108-09.

Before the nonrecognition rule can be applied to the maps in this case, however, two factual determinations must be made: (1) Did Frazell contribute the maps in question to the oil venture or did he keep them as his own personal property? (2) If he contributed them to the venture, what was their value at the time they were contibuted? As the burden of proof on both of these issues lies with the taxpayer, it might be argued that he is foreclosed in these issues because of the silence of the record on these points. However, we prefer to remand the case to the district court to permit it to make findings on these two issues. This disposition is in accord with the action

of this court in a number of recent cases. *E.g., Bisbee-Baldwin Corp. v. Tomlinson*, 5 Cir. 1963, 320 F.2d 929.

The judgment is therefore reversed and the case remanded to the district court to determine whether the maps introduced at the original trial were contributed by Frazell to the oil venture created by the 1951 contract. If the court finds that the maps were so contributed, it shall determine their value as of the time of their contribution. Such part of $91,000.00 as exceeds the value of the maps as determined by the trial court is properly taxable to Frazell as ordinary income.[2]

REVERSED AND REMANDED.

HUTCHESON, Circuit Judge, Dissenting:

This is an appeal from a judgment of Judge Dawkins in a taxpayer's suit for refund. The judgment is based upon a careful opinion by Judge Dawkins, reported in 213 F. Supp. 456. I was, and am, of the opinion that we should affirm per curiam on that opinion.

The district court's determination was that the transaction which gave rise to the litigation was a tax free exchange of property for stock within the meaning of Sec. 331(a) 1954 Code, and the attack of the appellant

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2 The parties have stipulated that the initial computation of any refund that may be due will be made by the Internal Revenue Service. It is expected that such computation will be made in light of all relevant Code provisions, including section 1301.

on the opinion and judgment largely turns on Louisiana law.

It seems to me that the district judge's opinion is untrovertible, that the contentions of the appellant are technical and unsubstantial, and that the majority opinion is not a correct statement of the law. I, therefore, dissent from it.

ON PETITION FOR REHEARING

(December 15, 1964.)

Before TUTTLE, Chief Judge, HUTCHESON and GEWIN, Circuit Judges.

PER CURIAM: In support of the appellees' petition for rehearing, briefs were filed by the appellees and three amici curiae. The Commissioner responded to these briefs, and the four proponents of appellees' position filed briefs in reply. After careful consideration of the arguments and authorities thus presented, we are persuaded that our original decision was a correct one.

Among the arguments presented in the appellees' behalf on this petition is that the first two sentences of Treas. Reg. §1.721-1(b)(1) require a different result from that reached in our original decision. The pertinent language is as follows:

> "Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership . . . whether made at the formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as com-

> pensation for services . . section 721 does not apply."

The remainder of the regulation makes it clear that what is referred to is the transfer of an interest in partnership capital. In 1955, Frazell received, without substantial restrictions, an interest in 13 percent of the capital acquired under the Wheless-Woolf-Frazell agreement. Frazell's interest was received primarily as compensation for services. Had he not been so compensated, Wheless and Woolf would have been entitled to the entire capital of the venture. In transferring a 13 percent interest to Frazell, they necessarily gave up a portion of their own capital interests. This fact is in no way altered by their having reserved the right to take the first $1,245,106 out of the profits of the venture. It has never been contended that this recoupment was a return of capital to Wheless and Woolf rather than a skimming of profits, and no such contention could be supported on this record.

Since we find that, on this record, none of the arguments presented on appellees' behalf requires an alteration of our original decision, the petition for rehearing is

DENIED.

HUTCHESON, Circuit Judge: I dissent.

PROOF OF SERVICE

I, W. Scott Wilkinson, attorney for the petitioners herein and a member of the Bar of the Supreme Court of the United States, do hereby certify that on the 22nd day of January, 1965, I served a copy of the above and foregoing petition for certiorari, including appendices attached thereto, on the United States of America, Respondent, by depositing copies of the same in the United States Post Office in a properly addressed envelope, air mail, postage prepaid, to the Solicitor General of the United States Department of Justice, Washington, D. C., and to Edward L. Shaheen, United States Attorney, Post Office Box 33, Shreveport, Louisiana.

Shreveport, Louisiana, this 25th day of January, 1965.

s/ W. Scott Wilkinson

W. Scott Wilkinson
Attorney for Petitioners, William D. Frazell and Martha T. Frazell

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In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 859

WILLIAM D. FRAZELL AND MARTHA T. FRAZELL,
PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the district court (Pet. 20–45) is reported at 213 F. Supp. 457. The opinion of the court of appeals (Pet. 46–54) is reported at 335 F. 2d 487. The order of the court of appeals denying a petition for rehearing (Pet. 55–56) is not officially reported.

JURISDICTION

The order denying the petition for rehearing was entered December 15, 1964. (Pet. 55–56.) The petition for a writ of certiorari was filed on January 26, 1965. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

QUESTION PRESENTED

Whether the court of appeals correctly held that the value of property received by the taxpayer as compensation for services to a partnership constituted taxable income.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1954:

SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items:

* * * * *

(26 U.S.C. 1958 ed., Sec. 61.)

SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.

(a) *General Rule.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

* * * * *

(26 U.S.C. 351.)

SEC. 721. NONRECOGNITION OF GAIN OR LOSS ON CONTRIBUTION.

No gain or loss shall be recognized to a partnership or to any of its partners in the case of a

contribution of property to the partnership in exchange for an interest in the partnership. (26 U.S.C. 721.)

Treasury Regulations on Income Tax (1954 Code):

§ 1.721–1 *Nonrecognition of gain or loss on contribution.*

* * * * *

(b) (1) Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at the formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61. The amount of such income is the fair market value of the interest in capital so transferred, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services. The time when such income is realized depends on all the facts and circumstances, including any substantial restrictions or conditions on the compensated partner's right to withdraw or otherwise dispose of such interest. To the extent that an interest in capital repre-

senting compensation for services rendered by the decedent prior to his death is transferred after his death to the decedent's successor in interest, the fair market value of such interest is income in respect of a decedent under section 691.

(2) To the extent that the value of such interest is: (i) compensation for services rendered to the partnership, it is a guaranteed payment for services under section 707(c); (ii) compensation for services rendered to a partner, it is not deductible by the partnership, but is deductible only by such partner to the extent allowable under this chapter.

(26 C.F.R., Sec. 1.721–1.)

STATEMENT

William D. Frazell, the taxpayer,[1] is a geologist. In 1951 he entered into an oil venture with Wheless and Woolf. The three agreed that Wheless and Woolf would provide capital for purchasing oil and gas leases in undeveloped property and that the taxpayer would supply his services and technical competence to locate likely mineral producing acreage and to secure contracts for the acquisition of the leases. Although the leases were to be acquired in the names of Wheless and Woolf, it was agreed that the taxpayer was to participate in the profits to a limited extent. When Wheless and Woolf had recovered their full costs and expenses, the taxpayer, upon written request, was to be assigned an interest in the properties. Thereafter, he would be entitled to the portion of min-

[1] Martha T. Frazell is a party only because a joint return was filed.

eral production allocable to his interest, subject to a proportionate share of all future costs and expenses of that production; would be chargeable with a pro rata share of any outstanding indebtedness against the property; and would be entitled to a proportionate share of the proceeds of any sale of the property. Prior to the time of the assignment of his interest to him, the taxpayer was prohibited from disposing of any of his rights under the agreement. In addition, it was agreed that the taxpayer would receive a monthly salary plus expenses. (Pet. 20–23, 46–47.)

The venture was successful. In five years Wheless and Woolf advanced about $1,245,000. Early in 1955 it became apparent that their advances would be recovered and the taxpayer could begin to participate by November of that year. In April 1955, the 1951 contract was terminated and all properties acquired under it were transferred to the W.W.F. Corporation, a corporation formed specifically to receive them. The taxpayer was immediately issued 13 percent of the stock of that corporation, having a fair market value of $91,000. He did not report that amount on his 1955 tax return. The Commissioner included it in his income and determined a deficiency, on the ground that the amount constituted additional compensation for services rendered. (Pet. 23–24, 27–28, 47–48.)

The district court, overruling the Commissioner, held that a joint venture existed among Wheless, Woolf, and the taxpayer from the outset, and the taxpayer exchanged his partnership interest for stock in a tax-free transaction. (Pet. 28–45). The court of appeals reversed, with one dissent, holding that, even

assuming the existence of a joint venture, the $91,000 value of the stock received was income to the taxpayer. It reasoned that his receipt of property—a 13 percent interest in the Wheless-Woolf capital—in return for his services was taxable compensation to him. The court went on to hold that the amount of compensation was to be measured by the fair market value of the stock to the extent that value exceeded the value of any maps contributed by the taxpayer to the venture, if it was found that they were so contributed. It remanded to the trial court for further findings as to whether the maps were contributed to the venture and, if so, their value. (Pet. 46–53, 55–56.)

ARGUMENT

1. The decision below is clearly correct. Section 61(a), *supra,* subjects to tax "all income from whatever source derived, including * * * [c]ompensation for services * * *." If property, instead of money, is received as compensation, the fair market value of the property is the measure of income. If the property has no value when received or if the taxpayer's actual command and control over it is substantially fettered—factors which may be interrelated—he does not realize income until the property gains value or until the restriction is removed. See *Commissioner* v. *Smith,* 324 U.S. 177, rehearing denied, 324 U.S. 695; *Commissioner* v. *LoBue,* 351 U.S. 243. The rule is the same when the property received is a capital interest in a partnership or a joint venture. Section 1.721–1(b)(1) of the Treasury Regulations explicitly provides that—

> To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 [providing for nonrecognition of gain or loss upon the contribution of property to a partnership in exchange for an interest in the partnership] does not apply. *The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61.* * * * [Emphasis added.]

In light of these principles, it is clear that Frazell was taxable in 1955 on the fair market value of the property (be it stock or a partnership interest) which he received as compensation for his services. Prior to 1955, Frazell's interest in the partnership, if any, was restricted as to alienation and contingent upon the existence of profits sufficient to match the capital contributions of the other venturers. In the words of the court below, it was "a springing executory interest" (Pet. 50) not yet taxable. If the 1951 contract had remained in effect, Frazell's partnership interest would have become possessory in November 1955, the end of the payout period; with the restrictions thus removed and the conditions precedent fulfilled, the interest would at that point have been taxable as compensation for services. Similarly, if the parties had agreed at the outset that Frazell's services would be compensated at the end of the payout period by the issuance of stock in the W.W.F. corporation, the fair market value of that stock would have been

taxable upon receipt. The transfer would not qualify for non-recognition treatment under Section 351(a), which specifically provides that "stock or securities issued for services shall not be considered as issued in return for property." The result should be no different, we submit, merely because the parties, having originally agreed that Frazell's compensation should take the form of an interest in the partnership capital, later changed their minds and converted that interest into W.W.F. stock shortly before its maturity. However the 1955 transaction be characterized, the basic fact remains that Frazell received in that year a fixed, definite, and therefore taxable interest in the business as compensation for his earlier services.

It makes no difference whether the W.W.F. stock is deemed to have been received (a) in return for the services themselves (with the partnership interest simply being extinguished upon the rescission of the contract); or (b) in return for Frazell's contingent interest in the partnership capital. Even on the latter assumption, the transaction is immediately taxable. For by converting it to stock, Frazell realized the full economic benefit of his right to compensation under the 1951 agreement just as if he had waited for the partnership interest to become possessory in November 1955. Cf. *Helvering* v. *Horst,* 311 U.S. 112, 117. Innumerable cases in the capital gains field have recognized that the sale or other disposition of a right to future compensation (or other ordinary income) constitutes merely a present realization of the income to which the right pertains, and that the property received upon such a disposition is to be taxed in the

same way as the income itself would have been.[2] Such transfers have never been regarded as the sale of a "capital asset" within the meaning of Section 1221 and, by the same token, should not be regarded as a transfer of "property" within the meaning of Section 351(a). In sum, property (here stock) received by a taxpayer in return for a right to future taxable income as compensation for services (here the contingent right to a partnership interest) is immediately taxable as ordinary income whether it be regarded as a *quid pro quo* for the services themselves or for the claim to compensation for those services.

We have assumed up to this point that the taxpayer's interest, or potential interest, in the joint venture was an interest in the partnership capital and as such would have constituted income to him when received, as provided by § 1.721–1 of the regulations, supra. Taxpayer argues, however, that the other venturers did not give up a capital interest in his favor; that all he acquired, or would have acquired, was a "share in partnership profits"; and that such an interest is expressly excluded from the purview of the regulation (Pet. 2, 10–11). That contention is groundless. While it is true that Frazell's interest was not to become possessory until Wheless

[2] See *Commissioner* v. *Gillette Motor Transport Co.*, 364 U.S. 130, 134–135; *Commissioner* v. *P. G. Lake*, 356 U.S. 260; *United States* v. *Woolsey*, 326 F. 2d 287 (C.A. 5); *Bisbee-Baldwin Corp.* v. *Tomlinson*, 320 F. 2d 929 (C.A. 5); *United States* v. *Eidson*, 310 F. 2d 111, on rehearing 312 F. 2d 744 (C.A. 5); *Commissioner* v. *Ferrer*, 304 F. 2d 125, 133–134 (C.A. 2); *Holt* v. *Commissioner*, 303 F. 2d 687 (C.A. 9); *Wiseman* v. *Halliburton Oil Well Cementing Co.*, 301 F. 2d 654 (C.A. 10).

and Woolf had recovered their costs and expenses from the proceeds of the oil, the amount so recovered by the latter was not a return of their capital investment, but a return *on* their investment, *i.e.*, as the court below termed it (Pet. 56), "a skimming of profits" of the venture (presumably taxable to them as income). Moreover, the district court specified that (Pet. 22, 23) the taxpayer, after the payout to the other venturers, was to have an interest in the oil and gas properties and that he was to participate in any proceeds from their sale. His ultimate receipt of a share of the corporate capital through his stock ownership confirms the capital nature of his interest in the partnership.[3]

2. There is no conflict. In *Farris* v. *Commissioner*, 222 F. 2d 320 (C.A. 10), cited by the taxpayer, the contributing partner relinquished and the service partner received a full participating interest in the partnership capital in 1943, the first year of the venture. Although he should have included the value of

[3] Moreover, even if the taxpayer had only a net profits interest, that would still not shield him from taxation on the transfer of that interest to the W.W.F. corporation in exchange for its stock. The most it would mean is that Frazell would not have been taxed on the net profits interest at the time he "received" it (November 1955, the end of the payout period), but only as the partnership profits were actually earned over a period of time. But while the *receipt* of a bare right to future income (*i.e.*, the net profits interest) may not be a taxable event, the present realization of that income through an anticipatory sale of the right plainly is such an event. Accordingly, the value of the W.W.F. stock is no less taxable when received by the taxpayer in exchange for a net profits interest in the partnership than it would be when received in exchange for an executory interest in the partnership capital, as discussed above.

his capital interest in income in that year, the Commissioner—probably because that year was closed[4]—determined that, although there was no net profit from the venture, distribution to the service partner was income when the venture was terminated in 1948. The court of appeals correctly held that the distribution was a return of the service partner's capital and, since the distribution was less than the capital share, no income resulted. So also in *United States* v. *United States National Bank*, 239 F. 2d 475 (C.A. 9), the holding that property received upon the dissolution of a joint venture was a return of capital necessarily implied that the taxpayer became possessed of a capital interest in the venture at some time prior to its termination.[5]

3. There is no other occasion for review. The decision below depends upon the terms of the particular agreement. The issue is the oft-litigated scope of the gross income provisions of the Code (Section 61). No question of the taxation of partnership distributions (*e.g.*, §§ 721, 731) or of the tax effects of the contribution of property to a corporation (*e.g.*, § 351) is involved. While it is true that "joint ventures" are common in oil and gas financing and production, that term embraces a wide variety of contractual relationships, and the tax treatment of each arrangement depends upon its own particularities.

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[4] See *Farris* v. *Commissioner*, 22 T.C. 104, 112.

[5] *Kasishke* v. *Baker*, 146 F. 2d 113 (C.A. 10), certiorari denied, 325 U.S. 856; *Kasishke* v. *Keppler*, 158 F. 2d 809 (C.A. 10); and *Kaye* v. *Smitherman*, 225 F. 2d 583 (C.A. 10), certiorari denied, 350 U.S. 913, are not tax cases, and deal only with the existence of a joint venture, a fact which the court below assumed to exist here. (Pet. 48.)

CONCLUSION

For the reasons stated, we respectfully submit that the petition for certiorari should be denied.

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